No. 17-494

In the Supreme Court of the United States

South Dakota,
Petitioner,

v.

Wayfair, Inc., Overstock, Inc., and Newegg, Inc.,
Respondents.

On Writ of Certiorari to the Supreme Court of South Dakota

BRIEF OF *AMICI CURIAE* THE UNITED NETWORK EQUIPMENT DEALERS ASSOCIATION AND THE OWNERS' RIGHTS INITIATIVE IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*[1]

The United Network Equipment Dealers Association ("UNEDA") is an alliance of more than 240 dealers of used network equipment.[2] These secondary market suppliers work together to promote industry best practices, ensure the highest standards of product quality, and eradicate counterfeit and fraud in the secondary market. Although UNEDA members collectively generate over $2 billion in revenue, most UNEDA members are small and medium sized businesses, and would be adversely affected by the overturning of the physical presence rule for collection of state sales tax articulated by this Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). UNEDA has worked in support of enactment of the Online Sales Simplification Act introduced by the Chairman of the U.S. House of Representative Committee on the Judiciary, the Honorable Bob Goodlatte.

The Owners' Rights Initiative ("ORI") is an organization of over 20 companies and trade associations that have joined together to protect ownership rights in the United States.[3] ORI

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[1] No counsel for any party authored this brief in whole or part, and no person other than amici curiae or their counsel made a monetary contribution to the preparation or submission of this brief. Petitioner and Respondents have filed blanket consents with the Clerk of this Court consenting to the filing of briefs by *amici curiae*.

[2] A list of UNEDA board members can be found at http://uneda.com/board-members/.

[3] A list of ORI members can be found at http://ownersrightsinitiative.org/about/. UNEDA is a member of ORI.

members believe in the fundamental premise that **if you bought it, you own it**, and should have the right to sell, lend, or give away your personal property. ORI formed when *Kirtsaeng v. John Wiley & Sons, Inc.*, 568 U.S. 519 (2013), was pending before this Court. ORI is now dedicated to preserving that holding, and making sure that it is not undermined in Congress, the executive branch, or the courts. Likewise, ORI supports strong ownership rights in the patent context, as just articulated by the Supreme Court in *Impression Products, Inc. v. Lexmark Int'l, Inc.*, 137 S. Ct. 1523 (2017), in which ORI submitted an *amicus* brief. ORI members participate in the secondary market, which would be harmed by the burdens on small enterprises that would result from overturning *Quill*.

SUMMARY OF ARGUMENT

In 1992, this Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), affirmed its earlier holding in *Nat'l Bellas Hess v. Dep't of Rev. of Ill.*, 386 U.S. 753 (1967), that the dormant commerce clause prohibited a state from requiring that a seller collect sales tax on purchases by buyers in that state unless the seller had a physical presence in that state. This brief focuses on one of the many burdens reversal of *Quill*'s physical presence rule would impose on small and medium size enterprises: exposure to audit by the taxing authorities of 45 states and the District of Columbia.

To bring this burden to life, this brief will first describe in detail four typical members of UNEDA. Then, the brief will explain the burden that exposure to audit by all the jurisdictions that impose sales tax would have on business such as these four UNEDA members. Because state budgets are highly constrained, state taxing authorities would have a strong incentive to audit out-of-state businesses in the hope of recovering additional revenue. Due to the large number of taxing authorities, it is likely that in any given year, a small business engaging in interstate sales could be audited by five taxing authorities. The cost of responding to so many audits would seriously undermine the economic viability of these small businesses.

Further, even if state taxing authorities did not have a strong financial incentive to target out-of-state businesses, elimination of the *Quill* physical presence rule would still result in an increase in the

number of audits. Proper application of a sales tax regime requires careful classification of transactions—a task software does not meaningfully facilitate. States are likely to audit businesses to ensure that they are correctly classifying their transactions; states have a legitimate interest in guaranteeing the correct application of their law. While the Streamlined Sales and Use Tax Agreement limits the audit liability of sellers that use certified service providers to file their taxes, this limitation does not apply to audits relating to the classification of products and transactions.

ARGUMENT

In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court reiterated the simple, common sense rule it adopted in *Nat'l Bellas Hess v. Dep't of Rev. of Ill.*, 386 U.S. 753 (1967): a state could not require a seller to collect sales tax on purchases by consumers in that state unless the seller had a physical presence in that state. The *Bellas Hess* and *Quill* Courts recognized that requiring out-of-state sellers to collect sales taxes on purchases by in-state buyers would interfere with interstate commerce, in violation of the dormant commence clause. Although *Quill* dealt with catalog sales, the same principle applies in the digital age, where the Internet allows buyers to find sellers throughout the country.

Respondents in their brief describe the burden that overturning *Quill* would place on the thriving interstate commerce the Internet facilitates, particularly commerce involving small and medium sized businesses. Respondents' Br. at 30-38. *Amici* agree that eliminating the *Quill* physical presence rule would impose the significant costs Respondents identify. One set of costs, however, would be particularly burdensome on *amici*'s members: those resulting from exposure to audit by the taxing authorities of 45 states and the District of Columbia. The cost of responding to multiple audits every year would be ruinous to the small and medium sized businesses represented by *amici*.

To show the real-world impact of overturning *Quill*, this brief first profiles four of the members of *amicus* UNEDA. These profiles reveal small

companies with narrow profit margins that are heavily dependent on out-of-state sales. Next, the brief details the high potential cost of exposing small businesses to the possibility of audit by the taxing authorities of all the states where their customers reside. Given the constraints on state budgets, state taxing authorities likely will view out-of-state businesses as revenue sources. Falling within the jurisdiction of 45 additional taxing authorities, a small business could be audited by five or more in any given year. This could cause the business's profits to evaporate.

I. Small Businesses Engaged in Interstate Commerce Are Vulnerable to the Cost of Additional Audits.

The following profiles of four members of *amicus* UNEDA demonstrate that small businesses engaged in interstate commerce often have very narrow profits margins that would be diminished by new costs such as complying with audits.

1. **Duane Whitlow & Co., Inc.**, is based in Addison, Texas. *See* DWC-IT, http://www.dwc-it.com/. It is a family-owned business founded in 1977. The company sells used Cisco products along with new hardware and software products. It has total revenues of approximately $2 million, of which $1.2 million derives from sales outside of Texas. Every year it has roughly 300 out-of-state sales, and it has customers in 45 states. The company has five employees. The president and secretary of the company handle all administrative matters, and an

outside accounting firm takes care of the tax filings. Its profit margin is under five percent.

2. **Pan Atlantic Technology Corporation** is located in Hawthorne, New Jersey. *See* Pan Atlantic Technology Corporation, http://www.panatl.com/. It is a family-owned business started by a married couple in their basement seventeen years ago. It sells refurbished networking equipment such as routers, switches, and telephony, firewall, and wireless devices to customers in all 50 states. Almost all of its $3 million in sales are to customers outside of New Jersey. Last year, it had over 2,700 out-of-state sales. It has six employees, including one bookkeeper. Its net income is under $100,000.

3. **Hula Networks, Inc.**, is based in Sunnyvale California, and has two small sales offices in Colorado and Texas. *See* Hula Networks, https://www.hulanetworks.com/. It was established in 2001 by three former employees of a Cisco value-added reseller. Hula resells new and used network hardware, and provides professional services such as design, installation, and support. It has $12 million in annual revenue, $4.5 million of which is from 24 states other than California, Colorado, or Texas, where it has a physical presence. It has twelve employees, including two who handle administrative matters. Hula retains an outside accounting firm for tax filings. It has profits of approximately $300,000.

4. **Ethos Dynamics** operates out of Suwanee, Georgia. *See* Ethos Dynamics, https://ethosdynamics.com/. It is a partially woman- and Native American-owned family business

established in 2012. Ethos Dynamics is a reseller of refurbished servers and network equipment. It has U.S. sales of $1.3 million in 38 states. It has six employees, including one bookkeeper. Last year, it experienced a net loss of $33,300.

These companies share the following characteristics:

- Much of their revenue derives from sales to a large number of states in which they have no physical presence;
- They do not have large in-house accounting departments; and
- They have very narrow profit margins.

Exposing these companies to the cost of responding to audits by multiple state taxing authorities would have a detrimental impact on their economic viability.

II. Elimination of the Physical Presence Rule Would Significantly Increase the Number of Audits by State Authorities.

1. Under the *Quill* physical presence rule, a company is subject to audit by the federal Internal Revenue Service and the taxing authority of the states where it has a physical presence. If this Court overturns the *Quill* physical presence rule, a company could be subject to audit by the taxing authority of each state where it has customers. A small company like Pan Atlantic Technology Corporation could suddenly be subject to audit by an

additional 44 taxing authorities. Even if any particular taxing authority conducted an audit only once every ten years, on average the small company would be audited five times a year.[4] Responding to any single audit could easily cost over $10,000 in fees to an accounting firm. Matthew Heller, *Small Firms Pay Bigger Slice of Revenue in Audit Fees*, CFO (Feb. 26, 2015), http://ww2.cfo.com/auditing/2015/02/small-firms-pay-bigger-slice-revenue-audit-fees/ (small companies pay $5,000 in audit fees per $1 million in revenue). Five audits would translate into $50,000 in additional annual accounting fees. Moreover, five audits would be disruptive to the operation of thinly staffed companies.[5] GAO Report at 21 (describing the costs of making staff available, developing justifications for tax claims, and complying with document or information requests in response to state tax audits).

2. There is every reason to believe state taxing authorities would aggressively audit out-of-state businesses. Because of policy choices not to increase taxes to match growing expenditures, state

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[4] According to a Government Accountability Office report, a "representative from the tax department of one company with nexus in most states said that auditors return every few years to audit the company and that they are currently contending with 8 to 10 audits from different tax authorities." U.S. Gov't Accountability Office, GAO-18-114, *SALES TAXES: States Could Gain Revenue from Expanded Authority, but Businesses Are Likely to Experience Compliance Costs* ("GAO Report") 21 (2017). This company expects "audit related costs to grow with exposure to more jurisdictions...." *Id.*

[5] The burden of responding to an audit is not mitigated by the availability of rate calculation software.

governments perennially are short of resources. As of 2016, state governments had a cumulative unfunded liability of $1.1 trillion in health care costs for retired state employees. Daniel DeSalvo and Jeffrey Kuclik, *How Today's big Supreme Court case on public-sector unions could lead to a fiscal crisis*, Wash. Post (Feb. 26, 2018), https://www.washingtonpost.com/news/monkey-cage/wp/2018/02/26/heres-whats-at-stake-today-as-the-supreme-court-hears-janus-v-afscme-not-for-unions-but-for-states-balance-sheets/?undefined=&utm_term=.1e96252bb981&wpisrc=nl_politics&wpmm=1. This is on top of $6 trillion in unfunded public pension liabilities. American Legislative Exchange Council, *Unaccountable and Unaffordable* (Dec. 2017) https://www.alec.org/app/uploads/2017/12/2017-Unaccountable-and-Unaffordable-FINAL_DEC_WEB.pdf. Many states are experiencing budget shortfalls, even though sales tax revenues continue to grow and the national economy is relatively strong. *See* Terrence P. Jeffrey, *State and Local Income, Sales and Property Taxes All Hit Records in 2017*, CNSNews.com (March 22, 2018), https://www.cnsnews.com/news/article/terence-p-jeffrey/state-and-local-income-sales-and-property-taxes-hit-records-2017. Because of a shortage of funds, public schools in Oklahoma hold classes only four days of week. Emma Brown, *With state budget in crisis, many Oklahoma schools hold classes four days a week*, Wash. Post (May 27, 2017), https://www.washingtonpost.com/local/education/with-state-budget-in-crisis-many-oklahoma-schools-hold-classes-four-days-a-week/2017/05/27/24f73288-3cb8-11e7-8854-

21f359183e8c_story.html?utm_term=.d104b121cae3. *See also* Paul T. Hill and Georgia Heyward, *A troubling contagion: The rural 4-day school week*, (March 3, 2017), https://www.brookings.edu/blog/brown-center-chalkboard/2017/03/03/a-troubling-contagion-the-rural-4-day-school-week/; Suzanne Perez Tobias, *South East Kansas district implements four-day school week*, Wichita Eagle (April 19, 2016), http://www.kansas.com/news/local/education/article72631157.html.[6]

3. In the face of these budget shortfalls, out-of-state businesses would be an obvious target for state taxing authorities to audit.[7] *See* GAO Report at 21 (business representatives "fear...increased audits, should states gain expanded authority to tax remote sales"). State taxing authorities already have enormous leverage over small businesses within their jurisdiction, and this power would grow exponentially against remote businesses that would not be able to push back politically against unreasonable and unjustified audits. James H.

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[6] Indeed, Petitioner states that "at the very moment it passed the law at issue here, the Legislature felt compelled to raise the sales-tax rate to help increase teacher salaries." Petitioner Br. at 16. Moreover, South Dakota does not have an income tax, so it is particularly dependent on sales tax revenue.

[7] Because of state balanced budget requirements, states cannot engage in deficit spending, unlike the federal government. National Conference of State Legislatures, *State Constitutional and Statutory Requirements for Balanced Budgets*, http://www.ncsl.org/research/fiscal-policy/state-constitutional-and-statutory-requirements-fo.aspx. This means that any budget shortfall must be addressed by cutting spending or raising revenue.

Sutton, a certified public accountant in Florida, testified at a March 2014 U.S. House of Representatives Judiciary Committee hearing concerning the many unfair advantages taxing authorities, such as the Florida Department of Revenue, currently have over small businesses. These include:

- The threat of criminal penalties: $301 of unremitted sales tax over five years is a third-degree felony punishable by up to 15 years in jail and $5,000 in fines. *Exploring Alternative Solutions on the Internet Sales Tax Issue, Hearing Before the Committee on the Judiciary, House of Representatives,* 113 Cong. 72, 76 (2014)(statement of James H. Sutton)("Sutton").

- Burden shifting: Florida has the power to estimate sales tax with the presumption of accuracy, shifting the burden to the business to prove the estimate is incorrect. Sutton at 77. *See* GAO Report at 21 ("[A]ssessments prepared by revenue offices generally carry a presumption of accuracy. In practice, this places the burden of proof on the retailer to rebut claims made by revenue offices."). According to Sutton, Florida often estimates twice the historical average of tax due. Sutton at 77.

- Automated Collection Process: Florida has implemented automatic bank freezes and filing of tax liens with no human intervention. A tax warrant was issued against the Florida Supreme Court because the computer system truncated the

name of the intended defendant, the Florida Supreme Court Historical Society. *Id.*

- Piercing the Corporate Veil: Florida law allows the state to pursue a corporation's officers, directors, and shareholders for sales tax liability. It also authorizes the imposition of a 200% penalty on the owners of a failing business that owes sales tax. *See* Fla. Stat. § 213.29; Sutton at 77.

- Limiting right to payment plan: The Florida Taxpayer Bill of Rights grants taxpayers the right to pay taxes owed on a payment plan. Sec. La. Stat. § 213.015(10). However, the Department of Revenue decided to condition this right on businesses waiving the right to appeal and owners personally guaranteeing past liability as well as twelve months of future liability. Sutton at 78.

- Drawn-out audits: The typical sales tax audit takes between six and twelve months to complete, not including administrative challenges and appeals. *Id. See* GAO Report at 21 (describing a business that "dealt with an expensive audit that lasted 3 years").

- Denying right to appeal: A taxpayer must respond to the Department of Revenue's positions within 20 days of the date of the notice. According to Sutton, the Department often delays mailing the notice letter, thereby effectively shortening the reply period. Sutton at 78. Additionally, states often will not allow a taxpayer to challenge

an assessment in court unless the taxpayer has first paid the tax in full. *Id.*

- Outsourcing audits: Many states contract with third parties to perform audits, which may have a financial incentive to maximize collections from taxpayers. *Id.*

- Lack of Uniform Enforcement: In Florida, local Department of Revenue offices have the discretion to follow their own rules and procedures. Thus, one office may enter into installment agreements for no more than six months, while another office enters into twelve month agreements. *Id.* at 79.[8]

Sutton stressed that the hardships for businesses imposed by existing state audit procedures were "but a drop in the sea of turmoil happening right now to small business owners...." *Id.* at 76. He added that if sales tax collection responsibility, and therefore audits, extended nationally, "this turmoil will be unleashed on business owners all over the country." *Id.*

Small businesses, confronted by the unfair audit procedures of 45 states, and the cost of securing counsel in and travelling to remote jurisdictions, are unlikely to contest remote state tax authorities' interpretation of their tax law. GAO Report at 21. The businesses would be inclined to settle disputes simply to make the taxing authorities go away. *Id.* at

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[8] In addition to these unfair practices permitted by state law, Sutton documented instances of unauthorized abusive behavior by Department of Revenue agents. Sutton at 79.

22. In short, *amici* expect state taxing authorities to attempt to squeeze needed revenue from out-of-state businesses.[9]

4. Even if state taxing authorities did not have a financial incentive to target out-of-state businesses, it is reasonable to conclude that elimination of the *Quill* physical presence rule would still lead to an increase in the number of audits. Tax law is a complex matter, and states have a legitimate interest in ensuring that their law is applied correctly. While software to calculate the 16,000 different sales tax rates is helpful, a business must still decide how to apply those rates. A sales tax holiday, for example, might apply to purchases by consumers but not by businesses. Much of the equipment sold by UNEDA members could be used by both consumers and businesses. A UNEDA member selling into a particular state during a sales tax holiday must determine whether the transaction is to a consumer, and therefore exempt from the sales tax; or to a business, in which case it is not exempt. The state taxing authority could reasonably

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[9] The briefs of Petitioner's *amici* Colorado and 40 other states and the National Governors Association ("NGA"), et al., make abundantly clear that the states intend to extract sale tax revenue from remote retailers if this Court abrogates the physical presence rule. NGA, for example, describes in great detail the revenue losses it believes are caused by the physical presence rule, as well as the "severe" effects "of this obstructed revenue stream," NGA Br. at 11, particularly on public education. NGA states that "with the *Bellas Hess* and *Quill* shackles removed, States would once again be ... creating policy that fits their respective sales and use tax revenue needs...." NGA at 6.

wonder whether the out-of-state UNEDA member was making this determination correctly. Similarly, sales to resellers typically are exempt. But a reseller may have failed to renew its reseller's certificate, in which case the sale might not be exempt. Likewise, sales to non-profit entities might be tax exempt, but entities lose their non-profit status. Because the taxing authority appropriately would want to ensure that the out-of-state seller was correctly categorizing transactions and thus properly collecting the sales tax, audits inevitably would proliferate, to the detriment of small businesses.

5. Further complicating matters, if this Court replaces the physical presence rule with an economic nexus requirement, states are likely to establish thresholds for the collection of sales tax. That is, a retailer would be obligated to collect sales tax only if it has sales into that state above a certain threshold, *e.g.*, $10,000 in annual sales. *See* Minn. Stat. § 297A.66 Subd. 2(b) (exempting "marketplace providers" with less than $10,000 in annual sales in Minnesota).[10] A small business might hover near the threshold: one year it could exceed the threshold, and be required to collect sales tax; the next year it could fall below the threshold, and be exempt from the collection obligation. The state taxing authority could be expected to question these fluctuations in collections. In contrast, a large business probably

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[10] Under the South Dakota statute at issue here, a retailer must collect sales tax if it transacts more than $100,000 of business or more than 200 times annually with state residents. Petitioner Br. at 16. It is safe to assume that if this Court eliminates the physical presence rule, the thresholds most states would adopt would be significantly lower than $100,000.

would always exceed the threshold, and thus would not arouse the suspicions of the taxing authority.

6. Petitioner's *amicus* National Association of Certified Service Providers ("NACSP") suggests that the exposure to audits would not be unduly burdensome in states that have agreed to the Streamlined Sales and Use Tax Agreement ("SSUTA") because "when retailers have Certified Service Providers file their taxes directly, CSPs assume the primary responsibility for any jurisdictional audit inquiries." NACSP Br. at 23. *See also* Streamlined Sales Tax Governing Board Br. at 15. However, the SSUTA expressly states that its audit liability protections "shall not be available for a ... seller that has incorrectly classified an item or transaction into a product category certified by a member state." SSUTA Sec. 502(D). In other words, the SSUTA's audit liability protections do not apply against the most likely cause of audits: misclassification of transactions. Moreover, only 24 states are members of the SSUTA, meaning that its audit liability provision would not shelter businesses from audit by the taxing authorities in the non-SSUTA states.

7. Petitioner's *amici* Multistate Tax Commission ("MTC") and Federation of Tax Administrators similarly argue that "the chance of a smaller seller being subjected to regular audit is extremely small," MTC Br. at 28, because the likely return to a state from auditing a small business is small. This, however, is not the experience of UNEDA and ORI members; they have endured audits triggered by

trivial perceived discrepancies.[11] Furthermore, MTC qualifies its minimization of the risk of audit with the reference to "*regular* audit." The concern of UNEDA and ORI members is not that they would *regularly* be audited every year by every taxing authority. Rather, due to the large number of states, even *irregular* audits—for example, once every ten years by a given state—are sufficient to result in a small business being audited five times or more a year. Such an aggregate volume of audits is sufficient to wreak havoc on the operation of a small business.

CONCLUSION

For the foregoing reasons, the Court should reaffirm the *Quill* physical presence requirement.

Respectfully submitted,

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[11] According to one attorney interviewed by the GAO, sales tax audits of small businesses often produce revenue. GAO Report at 21. Additionally, state revenue departments have low-cost enforcement tools at their disposal, such as a letter audit. *Id* at 22. A revenue office sends a letter to a business stating that the office suspects it owes sales tax, and the "business incurs costs to prove the state wrong to avoid the assessment." *Id.*